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40 Letters Per Year

DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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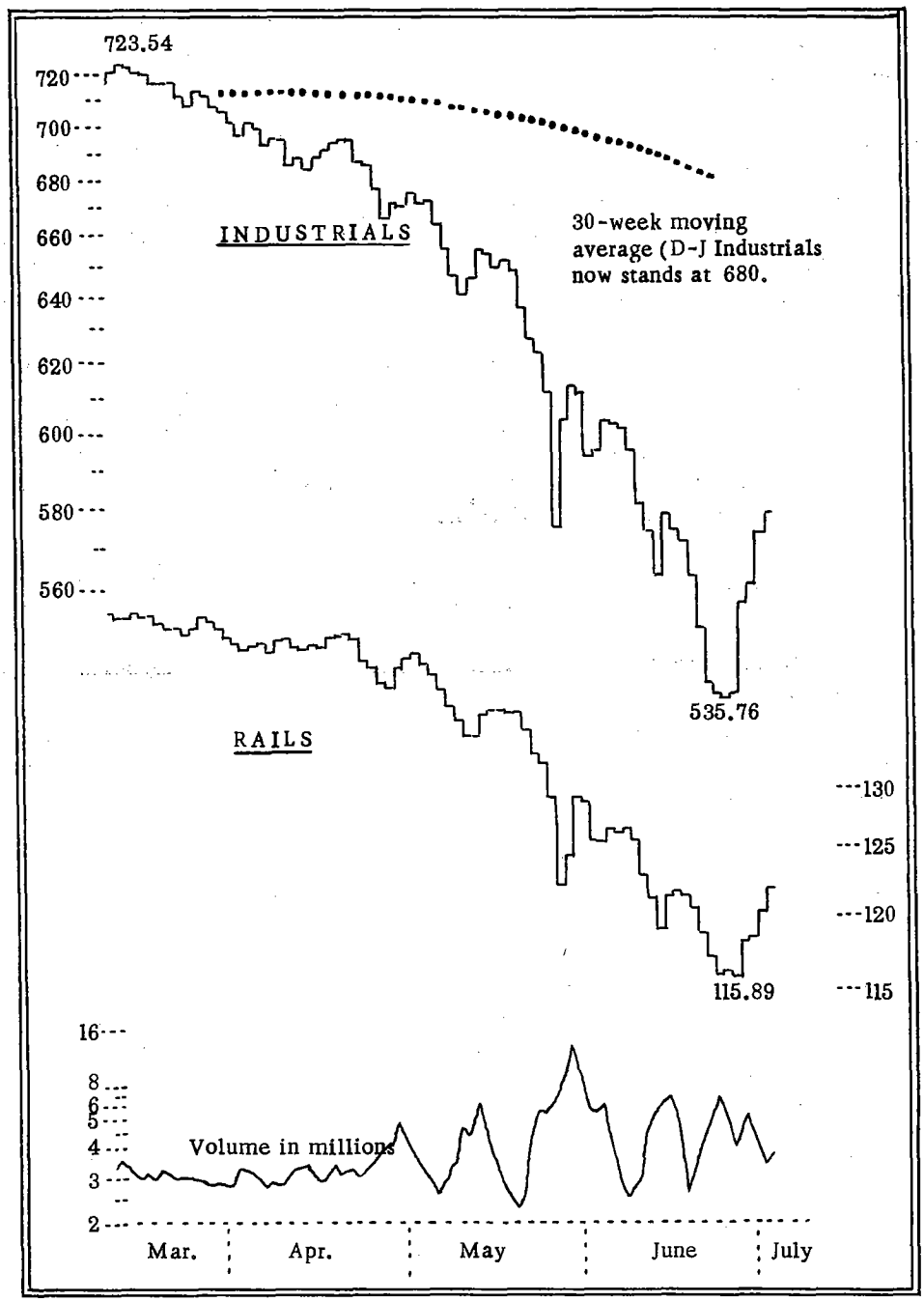
Registered with the Securities and Exchange Commission

July 5, 1962 Number 186

An acute observer of the national scene once wrote: "Never overestimate the knowledge of the American people; never underestimate the intelligence of the American people." When President Kennedy came to office, he promised all of us that the years ahead would be unprecedentedly difficult and that great "sacrifices" would be necessary. The American people are always impressed with the image of a gallant knight "on a white horse" and Mr. Kennedy appeared to be a pleasing mixture of Winston Churchill, Franklin Roosevelt and William Holden. When Washington started filling up with university professors the general consensus was that the country was finally back in the hands of the "thinkers". After all, how long can you listen to an ex-army general wrestle with the English language?

But as time went by, our lawmakers in Congress, always sensitive to "grass-root" opinion, balked at the wave of spending programs that inundated Capitol Hill. It was a case of "love him--hate his ideas". Lately, the "New Frontier" legislation seems to have struck a brick wall in Washington, and the President is now faced with a veritable armed revolt in Congress.

No student of the market would seriously blame the market action of the past six months on Mr. Kennedy. Markets topple when speculative structures grow too high; they advance when a bear move carries too far (in either a secondary or a primary sense). So far, however, the "sacrifices" that the American people have been called upon to make have been confined to a single area -- their pocketbooks. The descending stock market has produced sacrifices aplenty, and that was something that Washington neither appreciated nor desired.



THE MARKET Ever since the second bear leg began in March, bullishly inclined traders have been "jumping the gun" on each rally--the result being a compounding of losses in the average trading account. Many people who would not dream of shorting the "apparent" top of a bull market rally are only too willing to buy "the

 end" of a bear market decline. Both feats are equally difficult to bring off successfully, and the odds for making money in either situation are roughly the same.

Eventually, however, every bear swing overextends itself. There comes a time when too many boardroom pessimists are wringing their hands and too many amateur short sellers are crowding "the down elevator" (see page 4, Letter 185). In the face of this gloom, a rally will materialize. This rally will later be identified as the first advance in a secondary (upward) reaction.

On June 28 a violent rally advanced Industrials over 20 points with Rails rising "in gear". During the next five trading days this rally was extended to 45 points in Industrials, six points in Rails. The action of the market since May 28 has obviously been the most impressive since the second leg of the bear market began in March, 1962.

From the standpoint of a possible secondary (upward) correction, further evidence on the bull side of the ledger is as follows: on May 29 with Industrials in the 570 area, the five-day average of daily new lows struck a peak of 713. The highest figure since then, 256, came on June 27 with Industrials in the 530-40 area. Thus, more and more stocks resisted the bear trend as the Averages probed new low territory. Volume too, tended to contract with recent thrusts by the Averages into new low ground. This characteristic of volume was discussed in Letters 183 and 184.

Secondary reactions usually retrace one-third to two-thirds of the ground lost on the preceding bear leg. Secondaries generally last three weeks to as many months. Most important secondary corrections come in the form of two distinct upward swings. The two upward movements are often separated by a violent decline which may occupy a few days to a week or more. Obviously, only the gambler can buy correctly for the first upward swing. Such buying implies an ability to pick the exact bottom of the preceding major bear leg.

Following the termination of the second bear legs in 1929, 1937 and 1946, sharp rallies occurred, and these rallies (which constituted the first stage of the upward corrections) lasted approximately five to ten days. Thereafter, a period of backing and filling took place -- followed by a violent downward break. The breaks traced bearish-appearing downward zig-zags in the Averages and served to discourage early buyers. Each of these breaks succeeded in wiping out 50% of the initial rise (in 1946 almost all the initial rise was erased). Following the sharp drop, the best and "safest" part of the secondary rise (the second stage) occurred. This is the only part of a bear market correction which can be "played" with any degree of safety.

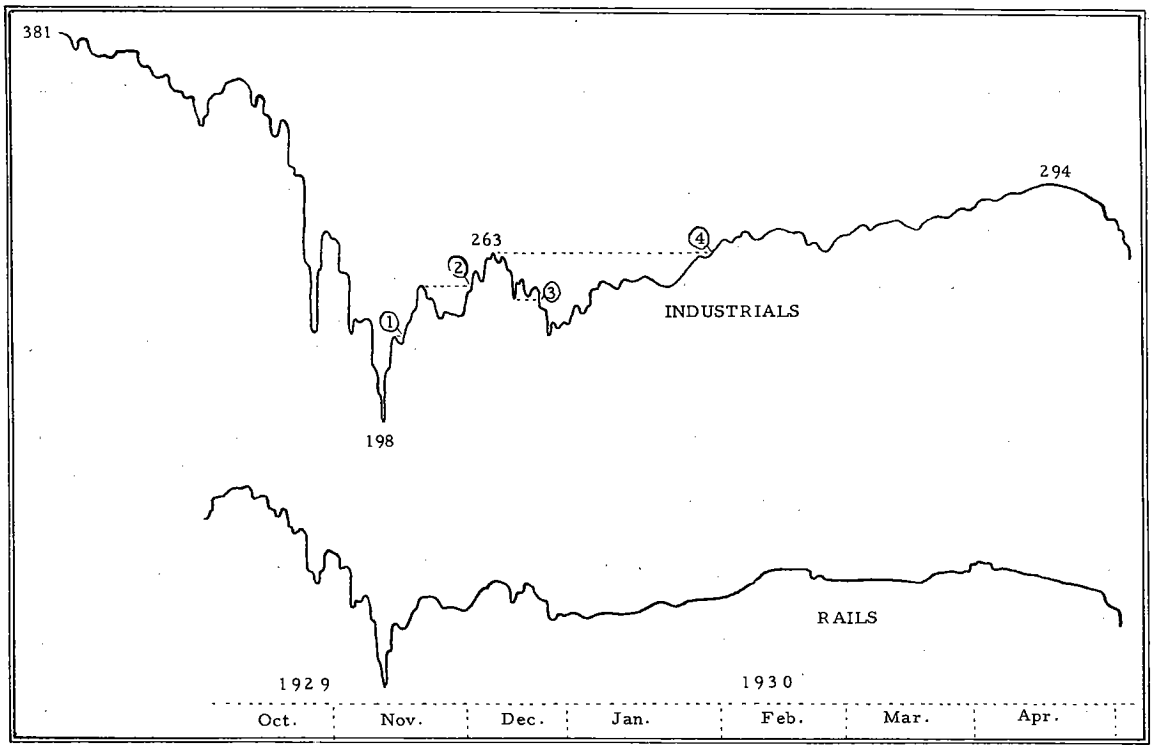
The question now is -- at what point (if any) is the speculator entitled to enter the market? In my opinion, past history suggests the wisdom of now waiting for a possible sharp break, the type of break which followed the initial secondary rises in 1929, 1937 and 1946. Such a drop may produce a day of large (even frightening) volume, but if both Averages can hold above the extreme lows, the odds favor the beginning of the second stage of the secondary correction. If the drop is to come, my guess is that it will arrive within the next one to three weeks. It should succeed in separating the majority of early bulls from their stocks -- but it should not take both Averages to new bear market lows (the lows were Industrials 535.76, Rails 115.89).

PLAY A CORRECTION? The question might be asked: "How well can one expect to do during an upward correction in a bear market?" History provides the only possible answer to this question. Turning to the corrective rallies which followed the second bear legs of 1929, 1937 and 1946, we find that the 1929 correction retraced 52% of total losses sustained by the Industrial Average from the preceding bull market peak. The 1937-38 rally retraced 25% of total losses, while the 1946-47 correction recouped 43% of total losses. The average percentage of retracement in the three bear market corrections was 40%. Referring to the 199 point Industrial drop from December, 1961 to June, 1962, an average retracement might be expected to make up perhaps 40% of the loss. Such a rally could return Industrials (assuming the June 26 close of 535.76 marked the end of the second bear leg) to about the 615 level.

If a trader were skillful enough to buy within 20 points of the bottom and sell 20 points from the top, such procedure might provide him with 40 Dow Industrial points as a contra-trend profit potential. Is such a movement worth playing? Rhea used to say that in the market, you may possess all the knowledge available, but in the end "each man must kill his own snakes."

Two points worth considering: Historically, post-crash recoveries tend to retrace 40 to 60% of the ground lost during the preceding bear leg. If the correction can carry nearer 60% than 40%, the chances for making money will obviously be greatly increased. Point two: In a wild, erratic, post-crash market, the daily price movements can be breath-taking. If you are wrong in the morning, you can lose a quarter of your capital by afternoon. For this reason, many experienced market students prefer to leave bear market rallies entirely alone.

The chart on page 3 traces the path of the great 1929-30 secondary correction. It is interesting to analyze what might have happened to the careful trader during that period. In November, 1929, Industrials struck a low of 198, having collapsed from their 381 peak recorded two months earlier. The extent and duration of the decline suggested that any upward move could well be the beginning of a major secondary correction.



At point 1 on chart a tiny upward zig-zag appeared, and the trader might have been so bold as to take a position here (even though the zig-zag came 30 points above the 198 bottom). At point 2 a large upward zig-zag was formed, and this seemed to be a valid confirmation of bullish inferences drawn earlier. At point 3, however, both Averages broke below preceding lows (the sharp drop previously discussed) and here the trader probably would have paid the cost of insurance and disposed of most of his stocks (with but slight profit).

Another rally materialized, and at point 4 the preceding secondary high of 363 was bettered; Rails confirmed the upward penetration. This appeared to be a major bull signal, and the only thing that might have cautioned the knowledgeable trader was the fact that a bull market lasting from 1921 to 1929 was hardly likely to have been corrected by a bear market lasting only seven months.

Volume was huge following point 4, actually running ahead of peak volume in 1929. The trader who bought at point 4 would have garnered 31 Dow points by the time April, 1930 arrived. In April the great reaction ended, and the Averages went into a sickening collapse. Probable trading profits by the time the whole 96 point rise was completed -- (in my opinion).... perhaps 20 Dow points.

QUESTION "It is now generally accepted that this is a bear market. The consensus seems to be that following whatever rally is now in the making (say a rise to 610-50) there will be a new decline and the bear market will continue to probe the low 500's, 400's or what have you. But suppose we apply contrary opinion? Do you eliminate the possibility of a rise to greater heights than is generally believed possible. Can you foresee, by any stretch of the imagination, an advance to new highs by say one Average -- or a new bull market?" (H.M.R., N.Y.C. 5, N.Y.)

ANSWER The market can do anything. Those who deny this run the risk of losing their shirts. When a bear (or bull) trend is established, the odds favor that trend's continuing until proved otherwise. Now, if the Averages rise less than expected on a forthcoming correction (and that correction has probably started), then back and fill for a few months on dull volume (while holding above the bear market lows), the situation will be well worth reappraising. If the total short interest continues to rise in the face of dull volume, and the short interest ratio climbs into the 2.0 or more range (see chapter entitled "Tell-Tale Ratio" in the book, "The Dow Theory Today"), we will have a good deal of ammunition for our reappraisal. If all this occurs in the face of steady odd-lot selling and deteriorating business conditions, it will be that much more impressive, and it will suggest that the 200 point collapse of 1962 may have discounted all the bad news that is likely to occur over the next year or so.

If all this comes to pass, we will certainly have time to change our minds and reassess the situation. Certainly we will still be in a favorable position because the greater part of our holdings are in cash. Regardless of the odds for or against the conditions described above materializing, we know one thing -- such conditions take time. This is the great advantage that is given to the solvent investor at the termination of a bear market. It takes time to lay the base for a true bull swing; during this

 period, the solvent investor can quietly lay his plans.

STOCKS AND THOUGHTS I have stated in past Letters that the large investor tends to view the handling of his funds in an entirely different manner from the small operator. The large (or should we say knowledgeable) investor is interested first in conservation of capital, second in possible long-term investments, and last in possible short-term gains. The small (or amateur) operator reverses the sequence. He is interested first in a "quick profit", second in possible long-term profits, and last in conserving his capital.

During a bear market, "things" (whether stocks, real estate or Renoirs) undergo a process of deflation. Thus, preservation of capital becomes more important than ever when the primary trend turns down.

Many of us are acquainted with the amateur who was "bailed out" again and again by the rising primary tide of the last thirteen years. Our intrepid neighbor, who carried his stocks through the declines of 1953, 1957 and to a lesser extent during 1960, lived to see his equity "come back" each time. A bull market may make a hero out of the rankest neophyte, but this happy state does not apply during a bear market.

The following D-J Industrial stocks showed increasing short interests over the last three months. Figures in parentheses indicate points which, if touched, will indicate reversal of stock from bearish to bullish classification. For those who are willing to speculate on possible profits during a secondary reaction, I recommend confining purchases to these issues.

		April short int.	May short int.	June short int.	
Alcoa	(57)	8 (thousand)	10	12	
Amer. Tel.	(116)	9	10	52	If purchases are made, stop-
Beth. Steel	(39)	5	23	51	losses (or mental stop-losses)
DuPont	(194)	1	1.7	8	should be placed a reasonable
Gen. Foods	(76)	6	8	10	distance under each stock.
Proctor & G.	(66)	3	5	11	Stops should be moved up if
Sears Roebuck	(69)	22	29	30	and when stocks advance.
St. Oil N. J.	(53)	28	46	84	
U. S. Steel	(56)	19	25	39	

LATE NOTES As this Letter is written (Wed. 12 P.M., July 5) the market is advancing for the sixth day in a row. Odd-lotters have bought heavily over the past three days at a rate of ten shares purchased for every six shares sold. The correction of the violent rise from the lows should be a "beaut" when it arrives.

FORMATIONS ARE NEEDED I have included a daily chart of the "blue-chip" Firestone Tire & Rubber Co. The chart is typical of perhaps 80% of the stocks on the Board. Note the sharp panic break of Late May -- then the further decline into late June. So far, FIR has merely turned up and rallied into "supply". If the stock is to make any appreciable upside progress, however, some sort of accumulation pattern will have to appear. I have drawn a series of theoretical dots on the charts, and these dots complete an "inverse head-and-shoulders" formation. Such a pattern (if it appears) would allow for a further substantial rally. But the dots also imply that a sharp downward movement will be needed to complete the right shoulder (X on chart). It remains to be seen whether the majority of stocks will trace out valid reversal formation -- the type of formations which are sure to appear if an extensive upward correction is to materialize.

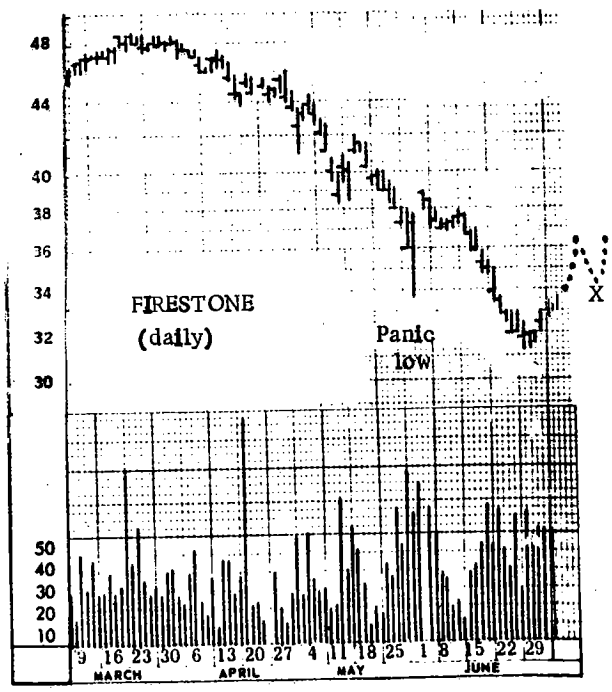


Chart of Firestone courtesy of Traders Research P. O. Box 2644, St. Louis 16, Mo.

FINAL THOUGHT Until proved otherwise, this is still a bear market. I want to stress again that the "risk" of missing a rise is not comparable to the risk of losing one's capital. The profits I don't make never keep me awake nights, but the losses I take can easily disturb my slumber.